

Core FT1:

Business & Industry , File 9 (1994 - present)
 ABI/INFORM®, File 15 (1971 - present)
 Gale Group PROMT®, File 16 (1990 - present)
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 Gale Group Computer Database , File 275 (full-text 1/1988 - present)
 Business Wire, File 610 (Mar 1999 - present)
 Business Wire, File 810 (1986 - February 1999)

Core FT2:

Dialog Global Reporter, File 20 (May 1997 - present)
 The McGraw-Hill Companies Publications Online, File 624 (1985 - present)
 Gale Group New Product Announcements/Plus® (NPA/Plus, File 621 (1985 - present)
 Gale Group Newsletter Database , File 636 (1988 - present)
 PR Newswire, File 613 (May 1999 - present)
 San Jose Mercury News, File 634 (Jun 1985 - present)
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Sub35FT:

McClatchy-Tribune Information Service, File 608 (Jan 1989 - present)
 American Banker Financial Publications, File 625 (1981 - June 2008)
 Banking Information Source, File 268 full-text (1994 - present)
 Bond Buyer Full Text, File 626 (November 1981 - April 2008)
 DIALOG Finance & Banking Newsletters, File 267 (1996 - present)

Set#	Query
L1	float\$3 with rate\$1 with note\$
L2	variable with rate with obligation\$
L3	taxable with float\$3 with rate\$1 with note\$

L4	debt adj3 obligation\$2
L5	(tax adj exempt) with bond
L6	municipality
L7	collateral
L8	purchas\$3 with asset\$2
L9	variable adj rate adj demand adj obligation\$
L10	security with interest\$1
L11	(interest investment) with default
L12	l1 and l2 and l5 and l6 and l7 and l8 and l10 and l11
L13	l1 or l3
L14	l2 or l4 or l9
L15	l10 or l11
L16	l13 and l14 and l15
L17	l5 and l16
L18	l6 and l16
L19	l7 and l16
L20	l8 and l16
L21	l5 and l6 and l7 and l8
L22	l21 and l16

87/9/1 (Item 1 from file: 626)

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Tax-Exempt Innovations and How They're Faring

The Bond Buyer - June 7, 1982, Monday ; Pg. 24

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The unrelentingly high interest rates in the municipal market have spawned a number of new and innovative tax-exempt securities. Some of these have found wide acceptance, while others turned out to be fads that faded as quickly as the hula hoop.

The new securities were devised to lure dormant institutional buyers back to municipals, and to suit the needs of the individual investors who

have become more important to the market than ever before. While net purchases of tax-exempts by banks and casualty insurance companies fell 64% to \$7.8 billion in 1981 from \$22 billion in 1980, individuals stepped up their buying tenfold to \$13.3 billion from \$1.3 billion, according to the Federal Reserve Board's flow of funds accounts.

So far, only the innovations geared to the individual investor -- variable-rate bonds, zero coupon bonds, and tax-exempt commercial paper -- seem to be enjoying wide acceptance. Two instruments designed with the institutional buyers in mind -- put bonds and super- sinkers -- are presently out of fashion.

With the recent arrival of yet another tax-exempt innovation -- the compound coupon bond -- now is a good time to evaluate how well these new financial instruments are doing.

Compound Interest Bonds: New Kid on the Block

If the State of Washington issues its \$118.8 million general obligation bond issue as planned this week, the sale will mark the debut of a new kind of tax-exempt security, the "compound interest" bond.

Timothy Kerr, the state's deputy treasurer, called the compound interest bonds a "major refinement of the zero-coupon bond." But it appears that the refinement benefits the issuer more than the investor; the compound bond's return and volatility will be essentially the same as the zero-coupon bond, according to several municipal bond experts.

Compound interest bonds, which some market participants refer to as "compound coupons," will comprise 25% of the Washington offering and mature serially from 1993 to 2002. The issue will be negotiated by a syndicate headed by Citibank.

According to William Ferrell, vice president in Citibank's public finance department, zero coupons and compound bonds are similar in that they eliminate the reinvestment risk inherent in conventional tax-exempt securities.

For the traditional bond, the yield to maturity is calculated on the assumption that the semi-annual interest payments can be reinvested at the bond's coupon rate. If market rates should decline after a few years, the bond's yield to maturity also drops because the interest payments must be reinvested at lower rates.

Zero-coupon and compound interest bonds eliminate that possibility because they pay interest and principal only when the bonds mature. This enables them to lock the return in at a pre-set rate.

The difference between zero coupons and compound bonds is in how that return is accrued. A zero-coupon bond is sold at a deep discount from the stated face value of the bond. When the bond comes due, it is redeemed at par, the investor's return is in the appreciation of the bond's price from original sale to maturity. By comparison, a compound interest bond is sold at face value, and its coupons are automatically reinvested, or compounded, by the issuer at the bond's stated interest rate.

Given the same yield to maturity for a zero-coupon bond and a compound interest bond, the major difference for an investor would be in how much he must pay for each security. For example, he might pay \$100 for a \$1,000 zero-coupon bond and receive \$1,000 after 20 years. For a \$1,000 compound interest bond priced at par, he would pay \$1,000 and receive \$10,000 after 20 years. The yield to maturity for both bonds would be 12.20%.

There is more for the issuer in compound interest bonds, however. Compound bonds "may be more attractive than zeros since they over- come legal restrictions in some states against deep discount offerings," George Friedlander of Smith Barney, Harris Upham & Co. Inc. noted in the firm's weekly Credit Market Comments.

"Both zero-coupon and compound-coupon bonds are primarily for the individual investor planning his estate. He must be willing to live without the high yearly coupon payments of current issues at par," said Scott Pierce, executive vice president in the national municipal bond department of E.F. Hutton & Co. Inc.

"There might be some problems when compound-coupon bonds start to trade on the secondary market," Mr. Pierce added. "Wall Street is not mechanically set up to price them. This could make them less liquid than zero coupons, which are priced just like any other bond."

The price volatility of the two instruments are the same on a per dollar basis, Mr. Ferrell noted. In other words, if an investor buys \$5,000 of 10% zero coupons and \$5,000 of 10% compound bonds, changes in market rates will alter the prices of the bonds by about the same amount, assuming that accrued interest to date is considered part of the price.

Mr. Pierce pointed out that individuals with odd sums to invest may find compound interest bonds less to their liking. For example, the Washington compound interest bonds will be issued in \$5,000 denominations. An investor with \$7,000 could buy only one of those bonds, leaving him with \$2,000 to invest somewhere else. If the Washington issue was structured as zero coupons, that same investor could put the entire \$7,000 into 14 bonds at \$500 apiece. (This assumes a maturity of 20 years and a yield a maturity of 12.20%.)

E. F. Hutton has been a major participant in seven of the eight zero-coupon issues that have come to market in the last six months, Mr. Hoey said. The seven issues have a total face value of \$350 million. The firm's largest zero-coupon bond deal to date had zero coupons with a face value of \$35 million included in an \$81 million Ohio issue of hospital facility revenue bonds for the Akron General Medical Center project.

Put Bonds: At Their Best When Rates Are Rising

The official label is "option tender" bonds. But the municipal market calls them "put" bonds because the investor can "put" them back to the issuer and get his investment back long before maturity.

Put bonds offer the investor the most security when interest rates are rising, because he can tender the bonds back, often at par, before too much of their value has eroded. This led to brisk sales in late 1980 and early 1981, when most of the \$1.6 billion in outstanding put bonds were issued. More recently, however, it has led to a decline in their popularity.

"The use of put bonds has declined somewhat because investors haven't been as worried that interest rates will rise," explained Sylvan G. Feldstein, vice president of Smith Barney, Harris Upham & Co. Inc. "Buyers are prone to buy bonds without puts to gain the extra return if they feel yields will decline."

In exchange for the right to put the bond, the investor accepts a slightly lower yield than conventional bonds of the same maturity. But he earns slightly more than bonds that mature on the same date as the put (which is often set at five years after the issue date). According to Mr. Feldstein, put bonds yield between 75 and 100 basis points less than conventional issues of similar maturity, but 25 to 100 basis points more

than bonds coming due at the put date.

The buyer can, of course, decide not to exercise the put and keep the bond. However, the issuers reserve the right to call the bond. Some issues can be called on their first put dates, while others have their first call date five years or more after the first put dates.

While put bonds have been used by public utilities, hospitals and industrial development agencies, most have been mortgage revenue bond issues secured by letter of credit. Mortgage bonds lend themselves to the option tender format because large portions of mortgages generally are pre-paid, giving issuers the wherewithal to cover the puts.

One of the largest put bond deals on record is the \$200 million Louisiana Public Facilities Authority single-family mortgage purchase bond issue, sold on April 1, 1981. The bonds are rated "Aa" by Moody's Investors Service. All but \$4 million of the Louisiana bonds have a first put date of Oct. 1, 1986.

Variable-Rate Notes: Money Funds Love Them

Propelled by a voracious demand from tax-exempt money market mutual funds and individual investors, the volume of variable-rate municipal bonds has climbed to about \$2 billion. By comparison, the more familiar tax-exempt commercial paper sector has sold only about \$1.7 billion.

A surprisingly large part of that volume was issued publicly -- mainly by E.F. Hutton & Co. Inc. According to Peter Hoey, first vice president at Hutton and national sales manager in its retail sales division, the firm has sold about \$1.2 billion in variable-rate tax-exempts. About half has been in short-term variable-rate demand notes, and half in long-term bonds known as "Hutton floaters."

Roughly \$740 million more in variable-rate demand notes have been privately placed with the tax-exempt money funds, accounting for about 10% of their assets, an industry spokesman estimated.

Demand notes can have maturities of as long as 30-year maturities, but the demand feature enables the investor to redeem the security at par on very short notice, usually seven days. They are bought primarily by the tax-exempt money funds, although considerable amounts sold to bank trust departments, individuals and even corporations.

The money funds buy them because they can consider the demand feature to be the effective maturity, so that even the 30-year demand notes qualify under the Securities Exchange Commission's requirement that the funds not buy debt with maturities of longer than one year.

Hutton's long-term floaters do not have a demand feature, but because their interest rate changes every six months according to an index, they can always be sold at or near par. "The price of a floater has never been below 99 or above 101," said Mr. Hoey. The index is calculated by averaging the market yields of Treasury bonds and bills over the previous 28 weeks.

Out of bounds to the money funds because of their lack of a demand feature, the floaters are sold mostly to individuals. Floaters generally return less than fixed-income bonds of similar maturity. The variable-rate bonds yield about 10 5/8% to 10 3/4%, while the Bond Buyer Index of 20 general **obligation** bonds is now around the 12% mark. Super-Sinkers: Most Likely To Be Called

The super-sinker is a long-term bond that, like the put bond, performs like a security with a shorter maturity. The trick here is that the issuer

makes it clear the super-sinker bond likely will be called long before it comes due.

Super-sinkers have been used only in mortgage revenue bond issues, where large numbers of bonds are generally called because of mortgage prepayments.

The standard way of calling mortgage bonds has been to redeem equal amounts of bonds from all of the issue's maturities. For instance, if the issuer found at the call date that he wanted to retire 5% of the issue, he would call 5% of each serial and term maturity.

When all the bonds likely to be called are lumped together into a single serial maturity, they are called super-sinkers. Such bonds behave like bonds of shorter maturities, currently returning 50 basis points less than conventional bonds of similar length, according to Robert M. Brown 3d, senior vice president of Lehman Brothers Kuhn Loeb Inc., an underwriter active in super-sinkers.

But "that 50-basis-point spread has narrowed," he added. "Investors have been wary that fewer mortgages will be prepaid, because in view of the high interest rates, fewer people will be selling houses. Also, the novelty of them has worn off, which has hurt pricing."

Mr. Brown estimated that \$200 million super-sinkers have been issued.

Lehman's most recent super-sinker offering was a \$47 million Tarrant County Texas Housing Finance Corp. issue of single-family mortgage revenue bonds, Series 1982A. The super-sinker maturity was in 2012, which consisted of \$6.9 million 12 7/8% bonds priced at par. These bonds can be called one year from the issue date.